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IMPORT LIBERALIZATION IN HUNGARY

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In the following the Hungarian import liberalization experience is analyzed, and within this special attention is paid to the timing and sequencing of liberalization, to the social forces supporting and resisting the introduction of liberalization measures, and to the social consequences of structural change. The research concentrates on the institutional aspects of the trade liberalization process: how the existing (inherited, reformed and newly created) institutional structure and its interests and conflicts have affected the elaboration, acceptance and introduction of the liberalization measures, and how they have influenced the consequences, the modifications and development of the regulations.

The import regime before liberalization

In Hungary the import regime of the strict command economy changed significantly with the reform of the economic management system in 1968. It was evident for the radical reformers of the time (see e.g. *Nagy* 1967) that the introduction of competition was one of the fundamental conditions needed to increase efficiency. This could not be realized if the economy remained monopolized and closed. One of the great successes of the idea of import liberalization and practical convertibility could be found in the resolution on the reform, made by the Central Committee of the Hungarian Socialist Workers' Party; this resolution included the principle that "the enterprises which have forints[1] can import". The idea was that planned import quotas would be abolished so that companies requiring imports could apply for and automatically receive import licences, and they would be allowed to change forints into convertible currency for this purpose. However, it soon turned out that including such principles in resolutions was not nearly enough to realize these aims.

Even if the Hungarian economic reforms of 1968 in many respects proved to be successful and economic activities—including imports—became freer and more efficient, it failed within a few years. Trade was not liberalized and in practice only the system of control and management of trade was changed.

The managers of the big state-owned firms supported the reforms inasmuch as it liberated them from many restrictions of the command economy and enabled them to become more independent and powerful. This also meant that they even

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[1] The forint is the domestic currency in Hungary.

wanted to get rid of the weak pressure for efficiency—emanating from the planning system. Many ideas of the reforms—such as a competitive market-economy, increased efficiency pressure, opening to the world economy—were frightening to the conservative managers, for such tendencies hurt their interests. At the same time, the elimination of the mandatory plan-targets by the reforms strengthened their positions and reduced the power of the central authorities.[2]

The system of protectionist import regulation that was developed in the early seventies was not so much exercised by tariffs, or explicit quotas, but by complex and informal methods of import rationing. These were kept strictly secret and were aptly called by *Gács* (1986) "a regulation based on consensus". The "consensus" was reached in a bargaining process between the "user" enterprises of imports and the monopolist trading companies. In this process both partners were interested in maintaining cordial relations and, as a consequence, importers showed considerable self-restraint in their import requirements. This import control system used the "base year" principle, meaning that the level of licensed imports was determined by the previous year's imports. In order to acquire a higher volume of imports, a difficult bargaining process was necessary, where applicants had to show what losses would be created by the lack of higher imports in national economic priorities.

This complicated system was developed mainly because one of the major aims of the Hungarian government at the time was to convince international organizations and the main western trading partners that the economic reforms had created a market economy in Hungary and the foreign trade regime in particular was similar to those of the developed countries, i.e. it was liberalized. They especially wanted to get rid of the disadvantageous "state trading" status, in order to show the international community that Hungarian firms were autonomous in their decision-making. The international community let itself be misled, and accepted the picture offered by the Hungarian government, which was much more attractive than the reality. (*Oblath* 1991b, p. 209; Nagy 1991, p. 224) Hungary became a member of the GATT, and later a member of the IMF and the World Bank. These institutions seemingly accepted that there were no import restrictions in Hungary, except those connected with tariffs and quotas for consumer goods and some basic raw materials.

The regular increase of imports could be financed in the seventies, partly because import demand was strongly restricted or suppressed, and partly because there was no strong opposition to the growing import surplus, i.e. to increasing indebtedness. This did not mean that the shortage of convertible currencies diminished: with more contacts with the developed economies, there was an increase in the unsatisfied demand of the enterprises for modernization, and of the consumers for better quality goods. It was a generally accepted view that centralized foreign

[2] *Szalai* (1989) provides a vivid insight of the struggles for power between the managers of the big firms and the bureaucrats of the central authorities after the introduction of the reforms.

exchange control was needed because of the shortage of convertible currencies. In fact the relationship was the reverse:

"It is not shortage that generates centralized foreign exchange control, but on the contrary, it is the central administrative decision making and management (centralized foreign exchange control included) that generates shortage—in particular, the shortage of foreign currency, and the tendency of growing debt."[3]

In 1982, after the military coup in Poland a serious balance of payments crisis threatened Hungary, creating a turning point in the import licensing system. Drastic measures were introduced; at the time these measures were referred to as "hand-steering". Import licensing was tightened for a time and licences were issued by a vice-premier item-by-item. Even when the import licences were granted, the actual foreign exchange transfers were in many cases delayed by the Hungarian National Bank, for these depended on its liquidity conditions. This acute shortage situation revealed that the central authorities had no intention of using financial methods to reach a new equilibrium, e.g. by exchange rate devaluation. They thought they "knew better"—i.e. which import items were needed, and which were not. In fact, of course, they could not know what should be imported, and which was the right choice from among several alternatives. They could only rely on the "basis" of the foregoing period, allowing—arbitrarily—more or less imports to the applicants. Thus a bargaining process was created, where relative power relations, or the "good connections" of various interest groups had more weight than any central preference or rationality. (Gács 1986; *Pásztor* 1988) As import licensing became tighter and arbitrary, it gave rise to "hoarding", i.e. an unreasonable swelling of demand. This showed that, by making the controls stricter, the chronic foreign exchange shortage was not alleviated but maintained and reproduced.

The hypocrisy of the Hungarian government increased and they did everything to hide the way in which the import regime really worked. For example, a police investigation was started against research workers for "divulging state secrets" by publishing, or intending to publish articles revealing the actual working of the import licensing system.

It should be noted that the resistance to a return to mandatory planning methods and to a less liberal trade policy did not come from the international organizations, like GATT, or IMF, but from the great firms. The latter wanted to defend the independence and autonomy they had previously achieved. They reacted strongly to the fact that the "hand-steering" method of import licensing significantly increased the uncertainty of getting the necessary import inputs in time. With the strong central intervention in "their affairs", the consensus between the managers and the bureaucracy disappeared and the struggle between them for power and authority became more fierce. The demand for import liberalization came first from the dissatisfied managers of some big enterprises; however,

[3] For more detail see: Nagy 1989, pp. 385–386.

for them it only meant the removal of constraints on importing the necessary materials, parts and equipment. They argued that without the freedom to import, they would be unable to compete on their export markets. Brought up in a nearly perfect protectionist environment, very few of these big enterprises were afraid that liberalized imports may endanger—through competition—their own products on the domestic market. It was not surprising that when in 1988 they understood that the government was preparing the introduction of a more general import liberalization policy (including not only materials and parts, but finished industrial products too) their professional organization, the Chamber of Economy, issued a declaration stating that they could agree to it only as a "long-term perspective".[4]

The preparation of import liberalization had already started in the mid-eighties in Hungary. In 1985 the Ministry of Foreign Trade commissioned a research report from the Foreign Trade Research Institute (KOPINT) concerning the feasibility of a gradual liberalization of imports. In addition the Hungarian National Bank started to investigate the experiences of other countries where import liberalization was linked to convertibility and the introduction of foreign exchange markets. From 1986 onwards more and more articles were published in the professional journals on the experiences and consequences of import liberalization and the introduction of convertibility. In these reports there were many hidden innuendos regarding the necessity to further the Hungarian economic reforms in these directions. (Nagy 1986; *Breitner* 1987; *Sipos and Urban* 1987; *Horváth* 1987)

The first elaborated proposal for import liberalization was produced by Gács (1986). This intended to start a gradual process by using two extreme cases from a competitiveness list prepared by the Ministry of Industry: i.e. the case of hopelessly uncompetitive products, and those products which could face import competition. The idea was that this would enhance specialization at both ends, resulting in the increased efficiency of the economy. According to the proposal the timing of the liberalization was to be announced in time for the enterprises to be prepared for the competition. However, this proposal was apparently strongly opposed both by the administration and by the managers of influential large state enterprises.

The process of trade liberalization in Hungary

When in the summer of 1988 representatives of the International Monetary Fund informed the Hungarian government that the liberalization of imports should not to be delayed any longer, preparations by the administration started in earnest. The Ministry of Trade rejected the proposal of Gács, mainly because the suggested introduction of strict normative rules in the selection of the gradual liberaliza-

[4] Cited by Pásztor (1993 p. 66).

tion process contradicted not only the interests of the firms concerned, but the protectionist stand of the administration. Also, it would have reduced the administration's direct influence on decisions concerning what and when to liberalize.

It has been mentioned above that the demand for import liberalization came first from some of the great firms that demanded the removal of the central controls on their imports of materials, parts and equipment. In this light it can be regarded as their success that in the first year it was mainly the import of investment goods, and in the second year that of material inputs for production purposes that were liberalized. It was only in the third year, i.e. in 1991, that a significant portion of finished industrial products had to face import competition.

There was a strong resistance to sudden import liberalization in different branches of the administration, especially in the Planning Office. While originally the Ministry of Trade proposed a 70 percent liberalization for 1989, the Planning Office affirmed that the planned balance of trade surplus could only be achieved if liberalization did not exceed 30 percent. They added that in the case of more than 40 percent liberalization "the government would have to a face an incalculable trade deficit".[5] At a time when one of the main concerns of the government was the way to cover the heavy debt servicing burden, the scaring of the authorities with an "incalculable" trade deficit obviously served only to deter them from liberalizing trade.

There were two reasons why the resistance of the Planning Commission to liberalization was defeated. On the one hand, the Hungarian government would have had to acknowledge that what it had asserted at the time when Hungary was admitted to the GATT had not been true, i.e. the official statement that imports had been liberalized and—except for a few quotas—there were no other obstacles to imports than tariffs was false. Moreover, the GATT and the IMF would have had to admit also that they had let themselves to be misled and had not recognized at the time that the Hungarian government's statement was untrue. The substitution of quantitative restrictions with tariff increases—as advised by trade experts—would only be acceptable if the existence of quantitative restrictions on the commodities concerned were acknowledged.

The other reason was that in the closing phase of the communist regime a group of radical reform economists got the upper hand within the administration. They wanted to demonstrate their seriousness and resolve to introduce fundamental changes in creating a market economy by proclaiming that only the fast opening of the economy could make the Hungarian enterprises efficient and competitive. One should not forget that in this short-lived "perestroika" period the reformists hoped to save the communist system and their own rule by a limited and "well-controlled democratization" and opening.

[5] Quoted by Pásztor (1993 p. 70) from the minutes of the Planning Commission.

At the end of 1988 it was evident that the Planning Office and the Ministry of Trade could not continue to licence in detail all imports; what remained to them was the elaboration of the lists of products to be liberalized and the decision on when this should happen. Their perspective was rather short-sighted, for they intended to delay the shock of liberalization in the first year by including in the list of liberalized products those which were always exclusively or largely imported. Since the beginning of import liberalization to restrain import demands, importers have been obliged to provide forward forint cover for each import transaction in a blocked bank account without receiving interest. (GATT 1991, Vol. I. p. 8)

The import liberalization programme in Hungary was in fact implemented faster than originally planned. In the original proposal of the government, accepted in 1988, imports accounted in convertible currencies were planned to be liberalized over the course of four years: between 1989 and 1992, in 20–35 percent increments. Due to the prevailing democratic and liberal political forces, to the pressure of the IMF and the World Bank and to the favourable experiences of the first period, the process was speeded up and finished in three years. By the beginning of 1992 about 90 percent of imports were liberalized, and about 70 percent of production had to face import competition. However, food products and consumer goods remained largely restricted. As most of the trade with the former Soviet-block countries was also accounted in convertible currencies, the same treatment and liberalization measures were extended to practically all imports.

The expected advantages of trade liberalization were numerous: it was believed that it would abolish, or at least diminish, the distortions of the incentives, prices and investment motivations; import competition and the free inflow of foreign capital would create a competitive domestic market in place of the previous extreme monopolization; changes in production structure, in technologies and in market allocation induced by competition would enhance efficiency; consumers would have a much larger access to more differentiated products, and to better quality goods which would be relatively less expensive. One of the strongest arguments of those reformers who supported the liberalization of imports was based on the previous failures of the reforms to generate competition on the home market. It turned out that the splitting up of some monopolistic large firms did not automatically create competition, because the new rivals (which had anyway been closely related to each other for a long time) found out fast that collusion was more advantageous for them.[6] This was partly due to the fact that all these firms remained state property and the small domestic market was strongly sheltered by import restrictions.

[6] In 1990 the national meat processing trust was decentralized into independent firms in each county of the country. A few months later the Competition Office investigated their collusion because they were raising prices at the same time and by the same percentage. The court imposed a severe punishment on them. Similar collusion was found among the firms of the decentralized milk processing trust. After a number of similar investigations and court sentences the firms became more careful about hiding their collusions.

Trade liberalization was an important part of a package of reform measures which, it was hoped, would stabilize the economy and create a competitive market economy based on private ownership. As far as this particular reform package was concerned, Hungarian import liberalization experience differed in two important respects from most of other countries sharing similar experiences (including other East European transition economies): on the one hand, it was neither linked to a drastic devaluation[7] nor to an increase of the tariffs rates. (Nagy 1993) The reason why Hungarian import liberalization was more cautious and gradual than that of some other East European economies can be traced back to the fact that the Hungarian economy was more open and much nearer to a state of equilibrium. Consequently, its transition to a market economy was not so much in need of "shock therapy" or a "big bang".

Speeding the liberalization programme required the defeat of its conservative opponents. The conservative counter attack was oriented not only against import liberalization, but against the restrictive monetary policy also. It was well known that for this purpose the threat of an uncontrolled balance of trade deficit would be the best argument, given the fact that the enormous debt burden was the most important impediment to stabilization. However, the old-style bureaucrats could no longer prevail. The international monetary institutions insisted on the continuation and even on the extension of the liberalization and stabilization programme. In addition, and not less important, imports did not surge excessively in the first year of the liberalization process, as has been expected. In fact they grew actually less than exports, thus providing a surplus in the balance of trade.

The implementation of the reform package and especially of import liberalization was strongly influenced by external factors also, of which the most important was the collapse of the Soviet Union and the CMEA. This involved a large reduction of trade among the CMEA's former members. It was partly due to the consequent recession in production that imports increased less than expected. This was followed by significant structural and market orientation changes in foreign trade, and it created very serious liquidity problems and insolvency in a great number of enterprises. The consequence was that their selection depended not on their efficiency, but on their liquidity, on their capital strength or creditworthiness.

The beginning of the import liberalization period was characterized by a general feeling of euphoria following the regained independence of the country, the end of Soviet and communist domination, the high expectations for the results of a democratic election and the introduction of a competitive market economy. Both producers and consumers had been isolated for a long time from western markets, even if the barriers to travel and to import were less rigorous in Hungary than in other Soviet-dominated countries. Foreign trade activities had remained

[7] In fact the value of the forint appreciated significantly during the liberalization period, as is described in the next section.

under the strict control of the authorities. Trading firms and representatives abroad were regularly infiltrated by secret police agents and most of the information and decisions were in their hands. Consumer demand for imported goods was strongly suppressed also, and such goods were available only to a relatively small section of the population (through tourist and business trips) and on the black market.

This explains the first reactions to the introduction of import liberalization measures: several tens of thousands of Hungarians crossed the Austrian border to go shopping. The feeling of euphoria and the "craze" for imported goods did not last long. The recession involved high levels of unemployment, the inflation reduced real wages and consumed much of previous savings. A restrictive monetary and credit policy and the import deposit requirement restrained import growth, even if the currency was not devalued, and the removal of quantitative restrictions was not substituted by other means of protection.

The expectations that the liberalization of imports would help exporters were fully fulfilled. Producers adapted fast to the advantages of the licence-free importation of better quality materials and parts, and they were able to satisfy better and faster the demand of their customers and thus in general they became more competitive.[8] It is difficult to judge the influence of import liberalization on domestic price movement, because the general feeling was that it contributed to the increase of inflation. However, one can hardly distinguish the higher prices paid for better quality or more fashionable goods from the price rises of the same quality products. The most important product groups where there was an obvious restraint on price rises were cars, consumer electronics and personal computers.

Import liberalization and exchange rate policy

At the time of the preparation of the transition to an export-oriented market economy in Hungary there was general agreement among economists devising the reform measures that beside a general deregulation of prices and wages, the liberalization of imports and convertibility would be necessary conditions of an efficiently functioning market economy. It was evident that both of these aims could be achieved only if a macroeconomic balance could be reached, which included the elimination of the excess domestic demand for imports. From the experiences of several countries' import liberalization attempts, it was learnt that to avoid the failure caused by an unsustainable deterioration in the balance of payments a substantial real exchange rate depreciation would be needed. (*Michaely* 1986; Nagy 1991) To avoid or reduce the shock of trade liberalization and the inflationary pressure of

[8] This is well documented in the case studies of *Borszéki* (1993), *Lamberger* (1993), Hajnóczy (1993), *Mohácsi* (1993), Pásztor (1993) and *Révész* (1993), although they could only observe the first period of the liberalization process.

deregulation and devaluation, it was suggested that a gradual import liberalization should be linked to the replacement of quantitative restrictions by tariff increases.[9] It was argued that this could reduce the excess demand for imported goods, and as a consequence, the devaluation could be less than would otherwise be necessary to achieve an acceptable balance of payments.

Neither of these proposals were accepted by the administration when trade was liberalized. Even though the forint was devalued several times, its real exchange rate significantly appreciated.[10] The depreciation of the nominal exchange rate was 50.6 percent in 1991 compared to 1988, versus the basket of currencies to which the forint was informally pegged.[11] However, as domestic prices increased much faster than the nominal depreciation, the real effective exchange rate—which remained relatively stable in 1989—started to appreciate strongly during 1990, resulting in a 19.5 percent appreciation in 1991 (if consumer price indices are used) or 13.4 percent (if producer price indices are used).[12]

The question of why, and how much the forint—instead of being devalued—has appreciated in real terms, is the centre of a debate which is closely related to the institutional interests of those who are taking part in the arguments. The National Bank and the Ministry of Finance, which dominate the exchange rate policy of the government, measure the real exchange rate changes by the producer prices, instead of consumer prices. The former has increased considerably less than the latter.

The Ministry of International Economic Relations[13] (being responsible for the trade policy, for the performance of foreign trade and especially for the trade balance) argues that instead of appreciation, devaluation was, and still is needed. It measures the real exchange rate changes using consumer price indices, and this results in higher appreciation rates. It is evident that devaluation, by making both exports and import substitution more profitable and imports more costly, improves

[9] The suggestion of Oblath (1991a) and Nagy (1991) was based, among others, on the findings of *Bhagwati* (1978), *Krueger* (1978), *NBER* (1974–78) and (1981–83), Michaely (1986), *Papageorgiou* et al. (1990).

[10] The real exchange rate compares the relative price index of a country to its nominal exchange rate.

[11] Up until the end of 1991 the Hungarian currency was pegged to a foreign exchange basket which reflected the revenue structure of exports. Since then it has been pegged to a basket composed of 50 percent ECU and 50 percent US dollars.

[12] There are great discrepancies in the evolution of real exchange rate indices. The above data come from the Blue Ribbon Commission study, see: *Marer and Oblath* (1992, p. 47) According to the computations of the National Bank the real exchange rate remained stable in 1988–1990, and appreciated 9 percent in 1991 only. See: *Baár* (1992, p.4) According to the computations of *Szentgyörgyvári* (1993, Table 1.), and also of the National Bank, the real exchange rate appreciated in 1991 by 10.3 percent if producer prices are used, by 10.1 percent if consumer prices are used, and by 13.8 percent if unit labour costs are used.

[13] It was called previously the Ministry of Foreign Trade.

the balance of trade and the performance of exports. This is the reason why this Ministry finds real exchange rate appreciation unacceptable and regularly expresses the demand for a devaluation in real terms.[14] It has been stressed that there has not been a single case of a country liberalizing nearly all its imports quickly and, given the collapse of the main markets, appreciation should be regarded as one of the major exchange rate policy aims. (Köves et al. 1993, p. 17) Yet all the other central and east European countries have linked their stabilization and liberalization policies to significant devaluations in real terms. (*PlanEcon* 1992; *Hrncir* 1993; *Jasinski* 1993)

On the other hand, the National Bank argued that there was no need for such a devaluation, for the trade performance of Hungary was much better than anyone expected, e.g. the volume of exports to developed market economies increased by 9.1 percent in 1989, 12 percent in 1990 and 21.7 percent in 1991. (*KSH* 1991, p. 177) The appreciation of the currency in real terms curbs inflation and all political forces in the country regard the reduction of the inflation rate as one of the basic aims of economic policy. Why should we devalue the forint further—the argument goes on—when the black-market rate is not significantly higher, either within the country, or outside of it? Finally, the significant inflow of foreign capital shows that investors regard the actual exchange rates on which they convert their imported capital to forints, and on which they can repatriate their profits, as satisfactory.

The size of real exchange rate changes depends on how one compares and aggregates the price changes of a country to those of international prices. As there are numerous ways to choose the commodities for comparison, and to weigh and aggregate them, there is ample room for different institutions to find their "own" real exchange rate indices, depending on what interests they intend to serve. The divergence of relative prices in Soviet-type economies compared to international price ratios was much greater than their relative development level could explain. Basic consumer goods, state-owned housing and services were strongly subsidized and invested capital was underpriced. As a consequence price liberalization and the elimination of subsidies became very sensitive political issues, for they hurt the interests of a great part of the population. For this reason they could only be implemented cautiously and gradually.

The literature on the developing countries' exchange rate policies reveals that the divergence of real exchange rates indices using consumer prices, or producer prices approximately mirrors the change in the relative price of the tradeable to the non-tradeable products of any given country. (*Aghlevi* 1991; *Edwards* 1992; Oblath 1993b) In the case of the transition in the post-socialist economies this relative price change reflects also the effects of the reductions and eliminations of huge amounts of subsidies and price-distortions. Oblath (1993b, p. 19.) has

[14] This argument was regularly expressed by the Minister. See also: Oblath (1993a) and *Köves et al.* (1993).

pointed out that even if the real exchange rate index based on producer prices "might be a suitable indicator of changes in export price competitiveness, in itself it may turn out to be misleading, [because of] the difficulty of comparing price indices in a period in which acute shortages prevail, with another in which the shortages have been eliminated. The practical implication of this problem is that real exchange rate movements before and after the elimination of shortages (i.e. the pre- and post-stabilization periods) are not likely to be directly comparable... With the elimination (or significant alleviation) of shortages, various types of costs previously associated with, e.g. queuing—evidently not included in the official price index—are also eliminated."

As the costs of waiting in queues or of substitution under constraint are omitted from the price index, one can point out more than the fact that prices and exchange rates are not comparable before and after the elimination of shortages. It means that the price indices in such cases overstate the degree of inflation, and as a consequence the real appreciation is less (or the devaluation is more) than calculated.

One can also question the argument that if the trade performance is good and the balance of trade changes are favourable, there is no need for devaluation. Compared to stable periods of smooth development, in a period of transition, stabilization and great structural changes, trade is more influenced by other factors than exchange rates. The very serious recession following the collapse of the CMEA trade and the financial restriction and stabilization policy of the government—with a host of bankruptcies and with mass unemployment—reduced domestic demand, including import demand. This created a situation in which survival became the most important aim for many companies. This meant that they tried to increase their exports wherever they could, and at whatever prices they could get. Analyzing the profitability of industrial exports, *Antalóczy and Koltainé* (1992) have shown that many of the firms they investigated even exported at a loss, i.e. sold in certain cases below their variable costs. The firms in question covered their losses by selling their stocks, buildings or equipment, or by the insufficient replacement of capital. The Blue Ribbon Commission stated: "it needs to be recognized that in the overall economic climate of 1990–1991, it was export or die for many firms. Therefore, some portion of exports may have reflected a distress response by enterprises to the severe shock of export losses on the CMEA markets". (Marer and Oblath 1992, p. 61)

Inasmuch as imports are reduced by the decline of production and exports expanded even if unprofitable, the improvement of the balance of trade tells us little with regard to the soundness of the exchange rate. It became apparent by the end of 1992 and the beginning of 1993 that the fast increase of exports to the developed market economies was in fact a temporary occurrence, because running through capital is a limited possibility for firms. Bankruptcies and liquidations of enterprises have been related to about one third of industrial exports and about half of food industry exports according to Köves et al. (1993, p. 7).

Ms. Baár, writing on behalf of the National Bank of Hungary, argues that devaluation is not an appropriate tool for achieving a significant and lasting increase in the profitability of exports. Export sales represented 11 percent of total net sales in 1991 and contributed by only 1 percent to the total decrease of profitability; the latter amounted to 5.9 percent in the same year. (Baár 1992, p. 5) Defending the real appreciation policy of the financial authorities, she used the very questionable argument that devaluation has only a temporary, short-term effect on the promotion of exports and improvements in the balance of trade.

The information content of the black-market exchange rates is also rather limited because the Hungarian currency is *de facto* convertible in the business sector, i.e. it is convertible for the great majority of foreign exchange transactions. Even in the case of households, where the forint is inconvertible, private persons are entitled to place any amount of foreign currency on foreign exchange accounts without the obligation to declare the source of it, and they are also authorized to take it out of the country. As a consequence the formally illegal, though not tightly controlled "curbside market" mainly shows the changing offer and demand conditions of tourists. Also, the propensity for household savings to be kept in convertible currencies represents only a very limited amount of the total demand for foreign exchange. While in the late eighties the black-market rate for foreign exchange was some 10 to 30 percent above the official rate, the gap started to narrow in 1990 and has since then become insignificant. According to several experts this evidence does not suggest a fundamental misalignment of the official rate. (Marer and Oblath 1992, p. 60)

Is the fact that Hungary recorded the greatest capital inflow among the Central and East European countries an indication that the exchange rates are correct? For example, in 1991 the National Bank recorded more than US$3 billion of medium and long term capital assets, half of which represented net foreign direct investment. It is obviously very difficult to get detailed information on what actually motivated foreign investors, but it seems quite probable that a major part of what was recorded as foreign direct investment was in fact in the form of short-term deposits with commercial banks. These have been attracted by the relatively high interest rates. It is estimated that only a small part of these investments have been spent on the much needed modernization of equipment and on technical development, i.e. on machinery imports. Consequently most of the capital inflow has contributed to the appreciation of the forint in real terms or, by extending the monetary base, to the inflationary pressure.

Hungary is a highly indebted country. At the end of 1991 its gross foreign debt in convertible currencies stood at $22.7 billion. This meant a more than $2000 *per capita* debt—one of the highest in the world. The annual principal payment to service the debt is approximately US$2.5 billion and the net interest payments are US$1.4 billion. Debt servicing amounts to about 12 percent of GDP, of which interest payments represent approximately 4 percent.[15] If it is measured against receipts from exports in convertible currencies (the "debt service ratio"), it declined from 97 percent in 1968 to 40 percent in 1991, due to the reorientation of trade and to the change to convertible currency settlement in trade with former CMEA countries.

In Hungary practically all significant political forces agree that the foreign debt has to be serviced fully, and no attempt has been made to renegotiate or to reschedule the external payment obligations; this is in contrast to the policy of several other indebted countries. Consequently, with creditworthiness achieved, the principal payments can usually be rolled over, meaning that the burden is reduced to interest payments, which in 1991 were US$1.3 billion. This was fully covered by the surplus on the non-interest current account (NICA) of US$1.6 billion in the same year. The net resource transfer of paying interest on the accumulated debt by the surplus of exports and the tourist trade is reduced by foreign direct investments, which amounted to US$1.5 billion in 1991. As the total inflow of capital (currency deposits, portfolio investments, new credits etc.), beside the foreign direct investments and the NICA surplus, largely exceeded interest payments on foreign debt, the reserves of the National Bank increased substantially. The government was very proud with these results and their financial experts regarded them as proof that there is nothing wrong with the actual level of the exchange rates, including their appreciation in real terms.

Nevertheless, one should keep in mind that much of the capital account surplus is the result of a substantial inflow of volatile short-term deposits, which can disappear just as fast as they came, depending on the political climate and on economic policy changes. On the other hand, foreigners make direct investments not to cover the interest payments on previous debts, but to make and repatriate profits—if possible even at an early stage. Consequently, even if capital inflow can temporarily alleviate the debt burden, in a longer-term perspective the net resource transfer has to be covered by the surplus of trade in commodities, services and tourism.

Oblath (1993a) has drawn attention to the danger of the development of an "exchange rate bubble" as a consequence of capital inflow and trade surplus following recession. The appreciation in real terms may diminish the competitiveness of producers, thus aggravating the recession and reducing the inflow of foreign capital.

The exchange rate policy is—as is clear from the above—closely related both to the general aims and priorities of economic policy and to the interests of the different institutions participating in the decisions on policy directions. If the major priority is to keep the current account in balance (as it was between 1982 and 1988,

[15]The debt-service burden could become even higher if GDP declines even further. See: Marer and Oblath (1992, p. 42)

because of the heavy debt burden and serious liquidity problems), then a continuous devaluation both in nominal and real terms is advisable, because it helps export expansion and curbs import increases. (Baár 1992, p. 2) Yet if the major economic policy target is to stop, or restrain inflation, then a real appreciation may become beneficial, because it can avoid the development of a "price-devaluation-price" spiral and it can cool down inflationary expectations. This was the case after 1989 and the reason why the financial authorities followed a policy of appreciation in real terms. Nevertheless, the field of manoeuvre for exchange rate policy is narrow in reality because the serious macroeconomic consequences of bad decisions soon become evident, as really happened when exports started strongly to decline at the end of 1992 and beginning of 1993. (Köves et al. 1993) On the basis of these experiences it can be stated now that those who criticized the government policy of real appreciation were right, and even if a very strong devaluation was not needed the exchange rate in real terms should have been kept in line with the inflation rate.

The conflict of interests and the reasoning of the different institutions concerning priorities hides a deeper layer of conflict. This seems to be even more important than the temporary changes of priorities and policies. The fundamental problem behind these discussions is: how much efficiency pressure should or could be exerted on the enterprises and when? The transition to a profit-motivated market economy means large scale structural change in an economy where profitability has been neglected. This involves great unemployment, capacity losses, devaluation of capital assets, and the loss of markets. The devaluation of the currency increases the profitability of both exporting and import substituting firms, and thus alleviates the pressure for structural change and helps the survival of these firms. As a consequence unemployment is reduced, or its growth becomes slower, and there are less bankruptcies and more time and possibility for adaptation. If, however, the nominal devaluation does not keep pace with the inflation rate, the efficiency pressure increases, life is harder and survival is more difficult for the firms. However, the necessary changes due to the increased competition arrive much faster. It is not an easy choice for policy-makers to find the right path by which the pressure is strong enough to create the conditions of productivity growth, but not so strong, as to ruin the perspectives of adaptation and create unbearable social tensions. One should add to this that the profitability pressure depends more on the motivation or incentives of firms and managers than on relative prices and exchange rates. This means that the privatization process, and the methods used for controlling the state-owned firms, play an even greater role in structural change.

The future of exchange rates is closely related to the convertibility of the forint, which in Hungary is beyond the scope of the import liberalization period. There seems to be general agreement that to reach the right moment for this in the transition period, a number of macroeconomic conditions have to be satisfied (Marer and Oblath 1992, pp. 8–10) and the adjustments of the exchange rates should increasingly reflect market forces, the financial authorities influencing it more and more by market interventions in order to stabilize it around the level determined by the offer and demand conditions. An important step was made in this direction in mid-1992. with the introduction of an interbank foreign exchange market. Commercial banks were allowed to hold a certain amount of foreign exchange on their own account and to trade it on a rather narrow band around the official midpoint rates. It is projected that by widening the range of interbank trading, and by increasing the amount of foreign currency citizens can buy, and by learning how a floating exchange rate system can be managed, a gradual integration of the interbank and curbside markets will be achieved.

Resistance to liberalization

It was surprising for observers of the liberalization process how little resistance was exerted against it in the period of preparation and shortly after its introduction, i.e. in the years 1988–1989. There are several possible explanations for this unusual occurrence. Gács (1991), for example, has argued that other shocks affecting the enterprises, like the liquidity crisis, the crash of rouble exports, increased inflation and high interest rates, and the serious uncertainties linked to transition and privatization, created more immediate difficulties and dangers for them than the longer term threat of import liberalization.

Another important factor has been the incentive system, which has influenced and even dominated the behaviour of Hungarian firms (in fact, their behaviour changed significantly in this period), but which has not moved in the direction of that might have been expected from enterprises functioning in a competitive market environment. In this respect it was far from true when the government's report to the GATT stated that state-owned companies: "operated the same way as the private sector, i.e. strictly according to commercial considerations. The major issue was not the ownership, but the *modus vivendi* of enterprises. In this respect there was no difference in Hungary between private and state-owned companies." (GATT 1991, Vol. II. p. 134. Report by the Government of Hungary)

If it were true, there would be no need to privatize during the transition process to a market economy. In fact, state-owned enterprises behaved very differently from the privately-owned ones, especially from those private enterprises which function in a settled and competitive environment. The political upheavals strongly affected the mentality, the motivation and the behaviour of managements: they had to prepare for the radical political change in the bureaucratic control of their enterprises, they had to anticipate privatization, work out how to keep their positions, and how to please both the future administration and the possible future proprietors. Another major concern was not to antagonize either the white collar or the blue collar working force of their enterprise by drastic changes or mass lay-offs, and if possible to be assured of their support, given the likelihood of future confrontations with the state administration.

Many firms were in a crisis situation, their major foreign markets in the CMEA countries had collapsed, domestic market demand had gradually shrunk, liquidity troubles had increased, and more and more loss-making firms went or were going to be bankrupt, and the domino effects of lost customers threatened them. The managers knew best how much their enterprises needed to be reconstructed, how much of the embodied capital was poorly invested and how little it could be moved or changed. Much of this inflexibility was due to the heavy financial cost of the inherited capital stock which they had to bear, this cost being out of proportion to the actual worth of this capital. There was great uncertainty as to the amount of superfluous real capital and the previous non-performing loans that could be written off without creating a wave of bankruptcies in the financial institutions.

Under such conditions it was no surprise that the managers became, and in a sense had to be, very short-sighted; their major concern became simply: *survival*, both for the sake of their firms and for themselves as managers. They did not care much about the problems of increased productivity, profitability, about flexible adaptation to changing demand and market conditions, and even less about the longer term danger of the competition that would be created by import liberalization.[16]

What the managers mainly perceived at the time of the preparation and introduction of import liberalization was an extended freedom to buy what they liked from where they liked for production and investment purposes. As it coincided with the shrinking supply from the former CMEA countries, the importance of such freedom increased greatly. It seems quite probable that if there had not been fast liberalization of imports the recession of production and the economic and financial hardships following it would have been much greater than they actually were.

Another explanation for the weak resistance to liberalization is given by Gács (1993): "the usual pressure groups resisting economic reforms were either non-existent or virtually ineffective... After the changes of 1989, the party-state did not exist any more and the behaviour of the state (including the branch ministries) was dominated by pro-liberalization policies of the government. Earlier, managers had traditionally derived their power from their close relation to the communist parties. With the disappearance of this background, most managers felt themselves discredited and for the sake of survival in their old positions, they did not attempt at making any noise, even when the interest of their enterprises became seriously

[16] Interviewing several managers of big state-owned enterprises at the time, Szalai (1992, p. 13.) observed: "Their basic objective is to preserve the framework of their enterprise, or at least to minimize its reduction, and not to pursue profitable economic activity."

endangered. Old trade unions were also discredited and the new ones were either supporters of the new government, or were too immature to act effectively".

As the experiences of previous trade liberalization attempts have shown, the strongest resistance jeopardizing its success or endurance has usually come from interest groups, like employers organizations, trade unions or agrarian lobbies.[17] It seems to be one of the necessary conditions of a successful liberalization episode that the interest groups hostile to it should be emasculated or paralyzed.[18] In many instances, as in the cases of Korea, Chile, or Turkey this was linked to an authoritarian, or dictatorial political change; in other words the introduction of military rule created a kind of "political vacuum". There are opposite examples of trade liberalization in which, instead of coercion, an agreement or compromise is achieved between the government intending to attain faster growth by opening the economy, and the different social interest groups. The latter agree to support or at least be neutral towards the introduction of a liberalization cum stabilization programme. This was the case with the liberalization agreement reached with the trade unions in Israel in 1962, with the Moncloa-Pact of 1977 in Spain, or with the Mexican stabilization pact of 1987. (*Székffy* 1993; *Stenzel* 1988; *Aspe* 1991)

In Hungary, however, trade liberalization was prepared by the last communist government and implemented after it was overthrown, i.e. not with the introduction but the removal of an authoritarian regime, and not based on a formal agreement with the interested social organizations. The different interest groups were not emasculated, and much of the institutional structure was left unchanged, but they were marked by temporary inertia and a policy of wait and see. Beside the fact that the surviving special interest organizations became weaker, less influential or discredited, for the reasons mentioned above, at the beginning of the liberalization process they did not realize the likely consequences of import competition.

Another factor was that after a very long period of nearly total monopolization in the economy, nearly absolute elimination of import (and domestic) competition, there was a very widespread understanding in society that a transition to a market economy was needed, and that this would be characterized by the private ownership of the factors of production in the competitive sector.[19] Thus this general mood in society eliminated practically all resistance to the introduction and legalization of competition, including competition from foreign companies. As a consequence, one can say that even if there was no formal pact between the new government and the interest organizations concerning trade liberalization, there was a tacit agreement supporting it.

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[17] See a comparative analysis in *Greskovits* (1993, pp. 26–32).

[18] This is paraphrasing *Olson*'s (1982, p. 75) statement that the emasculation of distributional coalitions by military occupation was a cause of fast growth in West-Germany and Japan.

[19] At the first free election in early 1990, practically all political parties were in agreement on these basic issues, including the former communist party.

It is also true that this understanding was based on many illusions concerning the advantages of a market economy in general and of competition in particular. It took a certain time until the exaggerated expectations proved to be unrealistic and both the management of enterprises and the different interest groups realized how much they were being or could be harmed by unrestrained competition.

The factors enumerated above contributed to the ostensible lack of resistance to import liberalization in 1989–1990. The behaviour of both the consumers and of the business community was motivated mainly by the advantages of the disappearance of many shortages due to the inflow of imported goods. However, the "honeymoon of trade liberalization"[20] did not last long, for during 1991 and especially since 1992 more and more voices could be heard demanding protection for domestic producers. Consumers complained of high prices and induced price increases due to imported goods, and producers deplored the increased crowding out of domestic production. Gács (1993) observed that the enterprises that first awoke to the new opportunities of protection were the newly-created joint ventures: "Investing with concrete business targets, more skilled in lobbying, and possessing more means for blackmailing domestic authorities, they were fast, aggressive and efficient. Many foreign investors targetted their sales neither on western markets, nor on eastern countries, but aimed to capture domestic demand".

This business tactic is of course familiar to multinational companies all over the world, but in the case of the previously centrally planned countries they could make use of the inherited monopolistic structures.[21] Thus it was joint ventures that were the first to ask the government for protection against import competition, elimination or reduction of tariffs on their inputs, and tax exemptions. Next came the agrarian lobby, which was strongly hit by the shrinking eastern markets and the loss of different subsidies. They succeeded in several instances in getting quantitative restrictions on imported food products in order to preserve much of the home market for domestic producers. Their argument was partly just, for it was true that their main competitors, the farmers in Western Europe, were strongly protected and subsidized and the sale of their surplus reserves at low prices menaced Hungarian farmers and crowded them out from the home markets.

These were followed by other industries demanding increased protection, like coal mining, which demanded that the state-owned electricity trust be obliged to buy only Hungarian coal up to a certain quota. Interest organizations representing light industry demanded quantitative restrictions on the imports of sensitive products, arguing that many partner countries used similar methods against Hungarian exports. Steel and cement producers also complained and asked for protection against imports being sold at allegedly dumping prices from the former Soviet-bloc

[20] The apt expression is that of Gács (1993, p. 19).

[21] This was the case with the General Electric-Tungsram electric bulb factory, Electrolux-Lehel refrigerator producing company, Unilever-TVK detergent factory and several others.

industries. They asserted that the continued subsidization of energy prices in these countries allowed them to export these products much below world market prices.[22]

As the demand for protection was increasing and the traditional means for achieving it were diminishing, interest grew in the introduction and extension of new forms of protection which did not violate the GATT rules.[23] The newly established Competition Agency of the government quickly learnt this and is in fact now teaching domestic enterprises how to prepare and present complaints dealing with anti-dumping and market disruption procedures. However, as the verification of these complaints is difficult and the procedures usually take a long time, they are not much of a help when foreign goods are flooding the domestic market.

More and more voices can be heard demanding increased administrative or procedural protection, such as special health, environmental, quality and trademark requirements. This would all mean that special licences would have to be obtained from different (and sometimes several) administration agencies for importing goods falling under these rules. The "new protectionists" have given advice on the setting up and changing of these rules and have declared that the procedure should be extended in such a way as to put the foreign firm at a disadvantage. One of their main arguments is that similar invisible trade barriers and discriminatory measures are applied against Hungarian products in developed markets, like those of the US, the European Union or Japan.

Another well-known method of providing preferences for domestic producers is the lack of neutrality in Government procurement. While the privatized sector is still small, and even in many joint stock companies the state owns a large part of the shares, the possibility of influencing procurement decisions in favour of domestic firms is great. Even if guidelines on tendering procedures exist, the policies, criteria and institutional procedures used in this field are still not really clear.

The Government's representative before the GATT Council pointed out that the requests for the reintroduction of import licences and for tariff increases had been growing by the hundred in the recent years. (GATT 1991, Vol. II, p. 137) It was observed that even if the authorities were opposed to these growing pressures, the resistance had weakened. As the popularity and support of the government was gradually decreasing and the next election for parliament was approaching, there

[22] The growing demand for tariff protection is discussed in Nagy (1993). The number of articles in the daily and weekly Hungarian newspapers demanding more protection for home-made products could be counted in tens in 1991, but numbered over one hundred in 1992. An Association for the Protection of Hungarian Industry (Védegylet a Magyar Iparért) was established in July 1992 by the top managers of the major industrial firms and the Hungarian Chamber of Economy asking well-known politicians, scientists, journalists and artists to join industrialists in a campaign for the survival of Hungarian manufacturing. (*MH* 1992).

[23] In response to a request of the Hungarian Ministry of Industry and Trade, *Török* (1992) prepared a report detailing the more sophisticated methods of "new protectionism" applied by several industrial countries and urged their implementation.

could be little hope for a more resolute stand in resisting protectionist tendencies. However, international obligations will limit and impede a significant retreat in the sphere of import liberalization.

Structural changes in imports

The most striking structural change in the liberalization period has been the strong decline in the share of import materials (mainly used as production inputs), and the fast increase of the share of consumption goods imports. The share of materials in total imports declined from 51 percent in 1988 to 37 percent in 1991, which meant a reduction in volume terms of 21 percent in three years. On the other hand, the share of consumption goods nearly doubled between 1988 to 1991 from 12 percent to 22 percent of total imports, increasing their volume by 71 percent (*Table 1*).

Table 1

The commodity structure of imports 1988–1991 (in percent)

Commodity groups	1988	1989	1990	1991
Fuel, electricity	13.0	10.9	13.5	15.0
Materials	51.2	50.3	45.9	37.1
Machinery	16.7	17.8	18.0	20.4
Consumption goods	11.8	13.8	14.9	21.7
Food, agriculture	7.3	7.2	7.7	5.9

Source: KSH (1990) and NGKM (1992).

Two major factors have influenced these changes in the structure of imports. On the one hand a "normalization" effect has corrected the distorting character of central planning on the structure of imports: it had previously strongly diminished the share of consumption goods and increased the share of material inputs. The collapse of eastern markets and the decline of production have contributed significantly to the decrease of import demand for materials. It should be noted that in the case of consumption goods the "normalization" effect worked even if the great majority of this product category was not liberalized but remained restricted by quotas. Liberalization of imports in this case did not mean the removal of the licensing system but liberation from the dictates planners imposed on consumers' satisfaction. The import structure of the centrally planned economies was distorted compared to some European countries. The share of consumption goods in imports was in the range of 11–19 percent for three East European countries in 1980, while in Western Europe their share was between 24–37 percent. The difference in these shares increased significantly over the next ten years. (Nagy 1993)

While the volume of total imports remained relatively stable in the import liberalization period, beside the important structural changes already mentioned, one can observe the growing share of machinery imports from 17 percent in 1988 to 20 percent in 1991, representing an increase in volume terms of 21 percent. This seems to be surprising taking into account that investments declined both in 1990 and 1991.[24] One probable explanation for this is that a significant proportion of the machinery imports are repair parts or inputs for consumption goods (like parts for previously imported cars or tubes for TV sets) and not investment goods. Therefore, much of the growth was due to these items.

Beside the changes in the commodity structure, a very marked reorientation of trade can be observed in *Table 2*. While the volume of imports from the former Soviet-bloc countries was reduced to less than half (45.5 percent), those of the developed and developing market economies increased by 44 percent in three years, between 1988 and 1991. The most explosive growth could be observed in the volume of consumption goods imports from the market economies: 196 percent and in machinery 112 percent. These tendencies can also be regarded as a part of the "normalization" of imports, in this case in the sense of its market structure. The political preferences of the ruling communist party and the planning system itself always had a strong bias for favouring trade with the Soviet Union and other CMEA countries, and this was especially strong with manufactures, like machinery and industrial consumption goods.[25]

Table 2

Trade volume changes 1988–1991 (1988=100.0)

Commodity groups	Economies in transition	Market economies	Total
Fuel, electricity	67.7	155.2	98.4
Materials	38.2	97.2	78.9
Machinery	19.7	211.8	120.5
Consumption goods	47.4	295.5	171.0
Food, agriculture	75.8	110.8	103.1
Total	45.5	143.9	101.1

Source: KSH (1991)

Beside the "normalization" of both the commodity structure and the market orientation of imports, the liberalization process obviously has had an effect which has caused serious concern: how does it affect domestic production? How far is it,

[24] The volume of investments declined in 1990 by 9.8 percent and in 1991 by 11.9 percent (KSH 1991, p. 3).

[25] For more detail see: Nagy 1985; 1990.

or can it become competitive, given the unimpeded inflow of foreign made products? The lack of competitiveness of the monopolistic, unresponsive state enterprises was one of the main arguments of the conservative economists in the socialist countries against opening and liberalization. One of the rightful concerns in the transition period is, how much efficiency improvement can be achieved and how soon will it be able to resist foreign competition, and how will privatization and foreign capital investments assist this development?

It is usual in international practice that at the beginning of the liberalization process temporary measures are introduced to curb imports and to give a breathing space to domestic industries in order to enable them to prepare for the freer competition with imports. As we have seen, trade liberalization in Hungary has not been accompanied either by a significant devaluation, or by tariff increases. The only measure implemented to restrain imports has been the import deposit system.

As the statistical categorization of production and trade is largely incongruous, it is very difficult to measure how far the penetration of imports has displaced domestic producers from their traditional markets. The great number of bankruptcy and liquidation procedures and the high level of unemployment certainly show that the effects of liberalization seem to have had very serious consequences, but it appears to be impossible to separate them from other factors, such as the collapse of the eastern markets and the general decline of domestic demand.

Gács (1993) computed import penetration ratios for some sectors and found that western imports penetrated at the expense of both domestic production and eastern imports in 1989–1990. It is quite likely that more domestic production was crowded out in 1991 and 1992, and much of the complaints of different industrial organizations in this respect were justified. One should also be mindful that after the very serious decline in production and capacity utilization, even a relatively small loss of the domestic market can be very painful for many Hungarian enterprises. One can also expect that the threat of losing traditional markets increases the efficiency pressure on the previously protected firms, and thus by modernizing their technologies they will be able to defend or regain their markets. It is one of the basic aims of import liberalization to enhance the productivity increase of domestic firms by competition, but this is only possible if they are able to survive and to adapt to the new conditions. Industrial and trade policy, which is gradually decreasing protection and increasing competition by trade liberalization, is in this sense an art which is hard to learn.

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